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Easy Lessons in Rural Credit

By

B. A. WALLACE
Extension Economist in Marketing
The Ohio State University

THE OHIO STATE UNIVERSITY COOPERATING WITH U. S. DEPARTMENT OF AGRICULTURE
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Contents

Foreword

Three years ago we issued the bulletin "Easy Lessons in Rural Credit." The Foreword read as follows:

> "The credit question is receiving increasing attention in Ohio farm circles. Low prices of farm produce not only lessen the ability of the farm to reduce old obligations, but may make necessary further borrowing. This problem has been more acute in the West than here, but now Ohio is feeling the pressure keenly. Farm organizations have expressed the intention to attack this problem with vigor this coming winter.
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> "Progress out of any situation — even intelligent discussion of it — must have a foundation in the facts of the situation. The only basis of helpful criticism of credit institutions or hope for their improvement rests in an understanding of how they operate and why. Accordingly, this bulletin has been prepared by the Extension Service, not to criticise, not to defend, not to offer remedies, but to present as clearly as possible a description of institutions and operations as they are, and thus to furnish a background for the discussion of the question and study of improvements needed in the system."

The bulletin seemed to meet a real need, and the continued demand for it, together with the many changes in credit institutions during the past two years, call for a revision of the bulletin. The wealth of material now available through the Farm Credit Administration makes it unnecessary for us to present the details regarding governmental agencies, hence the omission of some topics discussed in the earlier issue. On the ıer hand, many new problems are demanding discussion. The general purpose of the bulletin is unchanged.

Easy Lessons in Rural Credit

TRADE has existed from the earliest times. At first this trade was barter of one commodity directly for another. The many inconveniences of barter led early to the selection of some one commodity as a medium of exchange, and money had come into being. The inconveniences of storing and transporting metallic or other commodity money led to the use of paper money. But paper money — whether in the form of storage receipts, like our gold and silver certificates up to 1933, or in the form of promises to pay, like our greenbacks and other treasury notes — depends for its value on the credit standing of the government issuing it.

These same reasons that led to the use of government credit as a medium of exchange led similarly to the use of personal and bank credit. Instead of carrying one's money about in his pocket, one deposits it in a bank and checks against it. He also may, by giving his promissory note or bill of acceptance, borrow funds to be repaid at a later time. This borrowing may be in actual money, or may be in the form of an addition to his deposit account at the bank. One's ability to borrow depends on his personal credit standing; the acceptance of his check depends on the attitude toward his personal credit standing and that of the bank on which the check is drawn.

Deposit Currency — Our Principal Medium of Exchange

Billions of dollars' worth of commodities are produced, sold, and resold yearly. In one recent year, manufacturers paid 37 billions of dollars for raw materials and for labor 10½ billions. On the income side, the gross income of farms is in most years over 10 billions; of railways over 6 billions (two-thirds of which is at once paid out for labor, fuel, and supplies); and the total income of the people of the United States is often 70 to 85 billions a year. All of this income is received and either is paid out for goods to consume or is saved in some form. Retail trade of the United States amounted in a recent year to 53 billions. Many billions also are paid yearly for services of doctors, lawyers, hospitals, garages, laundries, schools and colleges, government officials, and other expense.

Practically all these raw materials of farm, mine, and forest, and the products of factories, change owners several times before they get to the final consumer. Each time a good changes owners it must be paid for. Is it not evident that the total exchanges to be paid for run up to thousands of billions of dollars yearly? Now note that most of the time buyers have in their pockets or homes probably not more than one billion dollars of money, and part of this is carried or kept around the home for weeks at a time. Is it not, then, equally evident that the great bulk of these exchanges are paid for in some other way than with money?

In all probability money itself does not pay for over 10 per cent of our exchanges; deposit currency — that is, checks on bank deposits — is by far the principal medium of exchange in this country and England, and to an increasing extent on the European continent. Its importance warrants a more extended attention.

Price Decline Due Largely to Decline of Deposit Currency.—Perhaps we should stop here to clear up a misunderstanding. The statement is often made that it was lack of money in circulation which caused the drop in prices with all the attendant difficulties. The following table is of interest in this connection:

Money in Circulation in U. S.

1916 (June 30)	$3949	million
1918 "	4481	"
1920 "	5467	"
1922 "	4463	"
1924 "	4849	"
1926 "	4885	"
1928 "	4796	"
1930 "	4522	"
1931 "	4822	"
1931 (Dec. 30)	5646	"
1932 (June 30)	5695	"
1932 (Dec. 30)	5674	"
1933 (Dec. 30)	5806	"

In examining the table we discover that in June, 1920, the amount of money in circulation was higher by 20 per cent than in the war years, yet in May, June, and succeeding months, a cataclysmic price drop was occurring. Then for the entire period 1922 to 1930 the money in circulation, while below that of 1920, was above that of the war period, and at no time was there any considerable decrease in the amount in circulation.

During the depression years 1930 to 1934 the amount of money in circulation was some 30 per cent higher than during the war years, and 15 per cent to 20 per cent above that of the fairly prosperous period 1922 to 1929. When one takes into account the price levels prevailing at the different periods, it is still more obvious that it was not lack of money in circulation which was cramping trade. As we pointed out above, money was probably in 1929 not paying for more than 10 per cent of our exchanges, the great bulk being paid for in deposit currency, namely, checks on money deposited in the bank. It was this part of our circulating medium, this part of our purchasing power, which failed us — of which more later.

The Commercial Bank.—A group of business men decide that there is need or at least opportunity for another bank in their locality. They form a temporary organization, subscribe for stock, secure a charter, and complete their organization. This charter may have been secured from state authorities, in which case the bank is known as a "State Bank." If the charter was secured through the U. S. Comptroller of Currency, the bank must carry the words "National Bank" as part of its name.

In either case, the new institution must, before receiving its charter, meet the requirements of state or national law; it operates under general supervision of government officials; it must report to them its financial condition as of whatever date a report is called for, and must open its books to their examination when requested. In larger cities the clearing house often examines its member banks even more rigidly than do state or national bank examiners. All these devices of charter, supervision, reports, and examination are primarily to protect the patrons of the bank.

A commercial bank, state or national, opens its doors on its first day with only its capital stock (and possibly some surplus subscribed and paid in with its capital stock). At once its leading stockholders, some of their friends, and some of the business men in the bank's vicinity transfer their checking account deposits from other banks to it. As time goes on other deposits are made, and ultimately a bank with, say, $100,000 capital stock will have several hundred thousand dollars of deposits — deposits which are equal to several times its capital stock.

The Check as a Medium of Exchange.—It is by means of checks drawn upon these deposits that most of the purchases of a community are paid for and most of its bills are met. And note right here that when you draw your check against your checking account, while it lowers the balance to your credit, it does not always or even generally mean that that amount of cash is paid out by the bank. If there is only one bank in your community, probably your check gets to the bank as a part of some merchant, doctor, or garage man's deposit, and merely means that part of your claim on the bank has been transferred on the bank's books to the credit of this depositor. If there are several banks, the process is a little more complicated, but little money is paid out. Your bank will send to some other bank, say, $2700 of checks it has received against that bank; it will get back possibly $3000 of checks that bank has received against it. Hence, the $5700 of checks will be settled by the payment of $300 only. Pretty certainly, too, this $300 will be paid, not in money, but in a bank draft[1], which is merely the bank's check against some larger city bank in which it has a deposit.

All this illustrates one big service of the bank. A few thousand dollars in the vaults of the bank become the source of change and pocket money, while the exchange of claims against deposits (through the drawing of checks against them) pays for 75 to 90 per cent of the community's exchanges of goods and services, running up in a week or month into hundreds of thousands of dollars. Bank credit is about nine times as important as all other media combined in carrying on the total trade of the United States.

Individuals, however, use checks not because of their social advantage, but because of their numerous advantages to the individual. A man with a checking account avoids the risk of carrying money except in small amounts; he pays by check and does not make out the check until ready to deliver it; the check is made out for the exact amount — no problem of "change" arises; the returned check indorsed by the payee constitutes a receipt. The writer had the experience of using checks he had given for rent over a four-year period to protect himself from a claim that he owed five months' rent, when he actually owed the one month's rent which he was there to pay. By entering on each check or check stub a word or two to indicate for what it was given, a year's checks show fairly well for what one year's income went —which of course does not take the place of an accurate record of income and expenditures, but is often convenient in the absence of such a record.

How Funds are Transferred between Banks and Communities. — To carry a little further our story of the transfer of funds between banks and

[1] The bank draft is the means of another of the services of the bank. One can get at the bank a bank draft or a cashier's check which he can use like a postal or express money order in paying bills due at some distant point.

communities, let us visit the large city. Its many banks do not each send to every other bank a messenger with the bunch of checks it holds against that bank. Instead, the whole group of banks organizes a "clearing house." To this clearing house, each bank sends its messenger with all the bundles of checks it holds against the other member banks respectively. He receives in return all the checks against his bank sent in by other banks, with a check or a bill for the balance due between his bank and the clearing house on the day's business.

Banks which are members of the federal reserve system may use it to "clear" their checks against banks in other cities. The 12 federal reserve banks "clear" their claims against each other through daily telegraphic reports to Washington, stating the amount of checks they are that evening mailing to each of the other federal reserve banks. The totals are debited and credited to the respective banks, and thus increase or decrease the share of each in the "gold settlement fund" maintained by the 12 federal reserve banks for the purpose.[1] Thus, millions of dollars of exchanges between cities and sections of the country are handled daily with an almost negligible actual shipment of money. The banking system and deposit currency, especially since the development of the federal reserve system, are the means of multiplying many times the efficiency, the working power, of our money.

It has been customary for banks to perform a great variety of services at little or no charge to their patrons. In the effort to protect the public from such a succession of bank failures as this country has had in the past ten years, new legislation has been passed and probably more will be passed soon. This legislation prohibits many speculative and other practices by which banks in the past made profits; the resulting reduced income of banks makes it necessary for them to make specific charges for a variety of services which they formerly furnished gratis. Hence the bank patron in future may be charged for each item of deposit, each check, or each collection item handled by his bank.

Some Other Services of Banks

Banks perform a variety of other functions.

The Savings Account. — At the savings department window one may deposit as little as $1.00 as a beginning of his savings account. He receives a "savings account book," in which will be entered each deposit, little or big, as it is made; interest is credited to the account quarterly or semi-annually. In order to withdraw funds the book must be presented.

In normal times one may withdraw any part or all of his savings account at any time; the bank usually reserves the privilege of requiring 30 or more days' notice before withdrawal. This is to protect it from the danger of a sudden "run" of withdrawals. When one has accumulated a considerable amount, such part of it as he is quite sure he will not need for a long time, he may put into a certificate of deposit, and then receive a somewhat higher rate of interest.

[1] Recent legislation has taken the gold from the Federal Reserve Banks into the United States Treasury, but the credit transfers between the banks are handled as before.

Perhaps a word should be added about the recent emergency. Savings accounts are not, like checking accounts, intended for liquid funds for everyday expenditure; savings deposits are "less liquid" and a much larger proportion of them are relatively permanent. Hence, savings banks do not normally carry so large reserves of cash as do commercial banks, and most of the funds can be put in long time investments like bonds and mortgages on farms and city homes and business buildings. If some customers withdraw funds faster than deposits come in, the bank soon must sell some of its mortgages to get the cash. But when a violent price drop cuts into incomes and cuts down deposits at the same time that many depositors are withdrawing deposits, practically all banks want to sell mortgages and bonds at the same time. When such a condition continues long, savings associations have a difficult time. Since 1931 much legislation has been passed to protect them, in the thought that as it is impossible for them to meet all demands for withdrawals, it will conserve the assets better, and will in the long run be better for depositors, if the bank is protected from withdrawals sufficiently to save it from failure.

The Safety Deposit Box. — Another function of a bank is the care of valuables. One may rent a safety deposit box for $2 to $3 a year. It has a double lock which requires in order to open it both the renter's key and the bank key. In this box one may keep his important papers, like deeds, contracts, notes, insurance policies, bonds, stocks, or his jewelry or diamonds. On any business day he can go to the safety deposit vault, sign the card belonging to his box, and have the opportunity to examine, add to, or withdraw the contents of it.

Trust Companies. — Frequently the word "Trust" appears as a part of the name of a financial institution. Properties left by bequest or otherwise to individual management often come to grief through the fraud, inexperience, or temporary or permanent incapacity of the person left in charge of them. A trust company handles many types of trusts and can have a specialist and a complete recording system for each type of business entrusted to it; it does not die, go insane, leave the country, or resign; it is always where it can be consulted; it is under supervision and it dare not risk fraud or dishonesty, as proof of either might be ground for annulling its charter. Even where the trust functions are performed by a department of the bank, the properties held in trust are not a part of the bank's assets and are not affected even in case of failure of the bank.

The man who wishes his wife relieved of the worry and dangers of handling his estate; one who wishes property cared for while he travels, or for orphans after his death; disputants who wish property cared for while the courts settle its ownership; courts or individuals in the choice of guardians — all may turn to the trust company to find a capable and faithful servant.

Investment Banking. — Sometimes a person has accumulated a considerable fund in his savings account, or inherits a few thousand dollars, or sells out a business. In any of these cases he is likely to consult his banker, who will be glad to advise him regarding sound investments. In case the banker sells him securities from a portfolio of them kept for that purpose he is acting as investment banker.

In the small town bank, this work (for it is work and requires constant study of investment opportunities and risks) is done by the president or cashier as an incident to his other work. In a larger bank, one finds an investment department, quite likely organized as a separate corporation, with men trained and experienced in this particular work.[1] This force of men not only buys and sells securities to and for the investing public, but is a constant adviser of the loan and trust departments in all questions regarding securities.

The Borrowing of Money or Credit

BUSINESS today is very largely conducted on borrowed funds or credit. For example, at the end of 1931, the railroad companies of the United States had outstanding 10 billions of stock representing ownership interest, and 12.7 billions of bonds representing indebtedness. A glance at the financial page of the daily paper will present bonds of manufacturers of autos, tires, oil, copper, steel, cigars, canned goods, and what you like; of mercantile firms and combines; of electric and gas companies — to say nothing of the billions borrowed through bonds by governmental agencies, American and foreign.

Most enterprises today are extensive short time borrowers. First, many enterprises start underfinanced, or if properly financed at first, may see real or fancied opportunities for expansion. Such enterprises are likely to get all their assets tied up in plant and equipment, and for working capital will be chronic borrowers, borrowing more at some seasons than others, but never out of debt entirely. Second, most businesses are more or less seasonal, and need considerably more capital at some times than at others. Now the manager who boasts, "We do not know how to borrow," may be fortunate, or he may be merely mistaken in his policy. Many a manager would say: "In our buying season we need, for 30 to 90 days, $50,000 more than we need at any other time of year; we think it sounder finance to borrow that $50,000 for the short time, than to raise our capitalization by that much and have $50,000 idle for 9 to 10 months of every year."

The farmer, too, has occasion for short time borrowing. We must get away from the idea of disgrace attaching to borrowing. No doubt thousands of people should be ashamed of being in debt for the things for which they are in debt. But the farmer, like other business men, must come — in fact, is rapidly coming — to recognize credit as a helpful tool in his search for profit. The building of a barn or poultry house, an investment to prevent erosion or to secure certified seed, the purchase of a car of feeder calves or sheep as a means of getting more out of corn or pasture or stubble fields, or an investment to save labor in the home or make it a better place to live, are a few illustrations of how farmers are using credit. Like any other tool, credit may be misused; it can be purchased at times when it does not pay to use it. One must use his lead pencil in buying credit if he is to buy it to advantage.

When one thinks of borrowing, the first institution to come to mind is the bank. Before we study the bank as a lending agency, however, we should

[1] Under present Federal legislation, banks may in the near future have to find other ways to handle the investment problems of their patrons, as present legislation threatens to require banks to give up "security affiliates."

examine the business paper which may be involved, the types of security which may be offered, and some of the elements that enter into determining the interest rate one has to pay.

Credit Instruments

When one buys merchandise at the local elevator without paying for it at the time in cash or by check, there are several ways in which his indebtedness may be handled by the elevator company. These are explained below.

If it is expected that the buyer will pay within a very few days, it may be that no record will be made except to keep on a sticker the elevator's copy of the sales slip; on payment, this sales slip may be stamped "Paid" and given to the buyer. Generally, the sales slip will be "posted to the ledger," in effect, the amount of the bill will be charged to the debtor in his own personal account in the ledger.

Promissory Note. — The buyer may be asked, especially if the amount of money involved is large, to give a promissory note, just as he would if he borrowed money at the bank. The essential features of such a note appear in the following form:

$300 GARY, OHIO, JUNE 16, 1935

Sixty days after date, I promise to pay to the order of.................

.... *(Creditor)*

Thirty-one & $\frac{no}{100}$ ———————————— *Dollars,*

with interest at 7%, for value received.

(Signed) A. C. DEBTOR

The note is an acknowledgment of the debt, it has a definite amount, a definite due date, and many people who would feel wronged if required to pay interest on an open account, expect to pay interest on a note. On the other hand, the note is no more collectible at law than the open account.

Bill of Exchange or Draft. — The bookkeeper may hand him a bill of exchange, or draft, in substantially this form:

GARY, OHIO, JUNE 16, 1935

To A. C. DEBTOR

Sixty days from date, pay to the order of Ourselves

Thirty-one & $\frac{50}{100}$ ———————————— *Dollars ($31.50)*

with interest at 6% until paid.

GARY ELEVATOR COMPANY
by E. M. Blank, Mgr.

Accepted at Gary, Ohio
Payable at..
Buyer's Signature..

The buyer signifies his acceptance by signing his name. This makes the instrument what is called a Trade Acceptance. In Europe this instrument is generally used in place of the open book account; a considerable effort has been made to get it into general use in America, but with little success. However, a number of Ohio companies have been using it of late. The seller of the merchandise may retain this trade acceptance in his own possession and collect interest and principal at the end of 60 days. Or he may sell the trade acceptance to his bank or any other purchaser.

In case the debtor has a checking account at the Gary National Bank, he may add to his acceptance the words "payable at the Gary National Bank," in which case the trade acceptance when due will be presented by whoever holds it at the time to the Gary National Bank for payment, and Mr. Debtor will find it in his next bundle of cancelled checks. In most respects the legal status of a trade acceptance is not materially different from a promissory note, but accepted in this latter way, it is obviously more convenient for all concerned.

Checks. — The ordinary check which one draws in paying a debt is merely a draft payable at sight on a bank in which one has funds deposited subject to his order. Checks are so commonly used today that ordinarily you may, in payment of an obligation, send your check to almost any person, firm, or place in the United States, and "the banks do the rest." This is another of the services performed gratis in the past for which banks are likely to make a small charge in the future. If for any reason you doubt the acceptance of your check you may go to your bank, write your check payable to this creditor, and then have the bank cashier "certify" the check. The cashier does this by stamping or writing across the face of the check the words "accepted," "certified," or "good," followed by the date, name of the bank, and his signature. He charges it at once to your account, and your creditor to whom you send it feels perfectly safe in accepting it at face value, because it is now a claim against the bank which certified it. In certain legal transactions, and often in bidding on construction contracts, the payment or deposit, if a check, must be a certified check. Sometimes a seller asks that your payment be by certified check, bank draft, or money order.

Sometimes instead of having your own check certified you ask the bank for a "cashier's check," which is his order on his own bank to pay to whatever payee you indicate.

As you read the following facts about checks, keep clearly in mind which of the parties to the check is being mentioned. If you write a check upon your bank in favor of Olaf Johnson, you are the "drawer" of the check, your bank is the "drawee" or "drawee bank" and Olaf Johnson is the "payee."

A Few Facts about Checks.

1. Some "nots."

Checks need not be numbered; the number is simply for the convenience of the drawer.

A check for less than $1.00 is no less legal or valid on that account.

The validity or negotiability of a check is not affected by the fact that it is not dated.

A post dated check — that is, one bearing a future date — should in general not be accepted; its standing until that date, and in some circumstances thereafter, is only that of a promissory note.

2. Other facts about checks.

A check should be promptly presented for payment, otherwise the drawer is excused from liability for loss due to the delay.

The drawee bank cannot question the purpose of a check.

The drawee bank is under obligation to honor a depositor's check for any amount not exceeding his balance; however, the depositor, not the payee, has the right of suit against the bank for failure to do so.

A bank cannot charge to a depositor's account a forged check, or one to which the bank obtained title by a forged indorsement. Therefore examine your cancelled checks promptly on receiving them from the bank, so as to notify the bank at once if any checks are wrongly charged to your account.

An overdraft may be regarded by the bank as a promissory note, and interest at the legal rate be charged.

When a payee presents a check for a larger amount than the drawer's deposit, the bank may simply tell him "insufficient funds"; it may, however, allow him to deposit the difference to the credit of the drawer, and then cash his check.

3. "In full of account."

If the amount of an obligation be in dispute between the parties, acceptance of a check marked "in full of account" closes the transaction. If the amount of the debt is clear and indisputable, one may accept a check marked "in full of account" and still have the right to sue for the balance.

4. "Bad checks."

Nearly every state now has laws making it a crime to issue a check on a bank in which one has not sufficient funds to pay it. If the drawee bank refuses payment for lack of funds, that constitutes "prima facie evidence"[1] of intent on the drawer's part to defraud.

In some states to give a bad check for a claim already existing does not constitute a crime, on the ground that no value is given for the check; in Ohio "the fact that the check was given for a past consideration does not" relieve the drawer from the charge of intent to defraud.

In another Ohio case, the drawer claimed that a third party had promised to deposit funds to the drawer's credit, and acting on that promise, he had drawn the check. The court held that the drawer was not relieved by such a claim, and was liable for drawing a bad check.

If the drawer of a bad check makes part payment on it, with a promise or even a promissory note for the balance, keep the check as a means of forcing payment.

Certificates of Deposit. — If you have funds which you do not expect to need for 6 months or more, you may deposit them with your savings or commercial bank, receiving therefor a form filled and signed by the proper bank officer, certifying that you have deposited in the bank the given sum, payable to you, six or twelve months later with interest at a given rate. This is called

[1] "Prima facie evidence" is understood by many to mean conclusive or final evidence. By no means. For example, if I have drawn a check on a bank in which I have insufficient funds, the law assumes that it was with intent to defraud, unless I can furnish evidence to satisfy the court that it was an honest mistake or had been due to no fault of mine.

a Certificate of Deposit. Legally, the bank cannot be compelled to pay you any part of these funds until the due date arrives. As a matter of practice, your bank would probably give you part or all of the money on your certificate any time you asked it, although it would not likely pay you any interest unless it had had the deposit for 6 months or more. A cerificate of deposit is negotiable; that is, by indorsement on its back it may be made payable to any other person and thus sold or applied on any obligation. A deposit on certificate cannot be withdrawn without presenting the certificate itself for cancellation or, in case of partial payment, for indorsement of amount paid. Such deposits are likely to remain in the bank a considerable period, and are known as "time deposits."

Warehouse Receipts or Storage Receipts. — The person or firm storing goods with a warehouseman receives a warehouse receipt therefor. This receipt among other things describes the goods stored and states the terms of storage. It may indicate that the goods are to be delivered to a specified person. If, however, it indicates that the goods shall be delivered to the bearer of the receipt, or "to the order of" a specified person, it is called a negotiable receipt.

The negotiable warehouse receipt is often used by individuals and cooperatives or other firms as collateral in borrowing money. The farmer who stores grain with his local elevator may: (1) leave the warehouse receipt with the elevator as collateral for an advance of an agreed percentage of the market value of the stored grain; or (2) borrow money from a bank or other lender, giving a promissory note and leaving with it the warehouse receipt as collateral security for the payment of the note. (Ohio in 1933 passed a farm warehousing law under which a farmer may get a warehouse receipt for grain stored on his own farm, which receipt has, with some limitations, about the same credit uses as the warehouseman's receipt.)

Bill of Lading. — When the railway company or other common carrier accepts from one a car of goods for shipment, it must give him a "bill of lading." This bill of lading indicates the nature of the goods, the number of the car, the points of shipment and delivery. It may, like the warehouse receipt, call for delivery to a specified person, or it may be "negotiable."[1] By indorsing a negotiable bill of lading from one to another, title to the goods may be passed while the goods are in transit.

The bill of lading is not used extensively as collateral in borrowing. It has, however, a relation to credit. Suppose you sell a car of hay to a buyer whom you do not know or whose credit you doubt. You may notify the buyer that you have sent to a bank in the buyer's town the bill of lading, with a copy of your invoice or bill for the hay, and a draft on him for the amount of the bill, with instructions to the bank to deliver the bill of lading to the buyer, only on payment of the draft. Without the bill of lading he cannot get the hay. When he "lifts the draft," that is, pays the bank the amount called for, he gets the bill of lading, presents it to the railway agent, and gets

[1] An order b/l is not strictly a negotiable instrument, because to come under the negotiable instrument law, an instrument must call for payment of a determinable sum of money.

his hay. The bank remits to you the face of the draft less its charge for its services — usually a small fraction of 1 per cent of the face of the draft.

Bonds and Stocks. — A bond is merely a specialized type of promissory note. When a corporation borrows in large amount and for a long period of years, it generally does it by breaking up the total amount borrowed into several separate notes, all of identical form but possibly for varying amounts, and offering for sale the notes, or "bonds" as they are called. Attached to each bond are the "coupons," each coupon a separate promissory note for the interest on the bond for a given period, usually six months. Bonds of less than 5 years to run are often called "Debentures."

Stocks are not primarily credit instruments. A stock certificate is the evidence of an ownership interest in the company, and an indication of the extent of that ownership. Stocks are generally of two kinds, common and preferred. Common stockholders are the "residual claimants," the ones who own all that is left after all other claimants are paid. One should not be misled by the fact that the certificate indicates a $100 interest. If you hold, for example, a $100 share of common stock in a company having $10,000 of common stock outstanding, you own a one-hundredth interest in the net assets. If the company would have $30,000 after all claims preceding the common stock are paid, your $100 share may be said to be worth $300; if the debts are equal to the assets, your $100 share is probably worthless.

Preferred stock is so called because it gives its holder certain advantages over the holder of common stock. A 6 per cent preferred stock, for instance, indicates that the common stockholder cannot receive any dividends on his stock until a 6 per cent dividend on the preferred stock has been allowed. One often hears this preferred dividend referred to as "guaranteed." This is not the case, for the directors cannot legally declare any dividend except when a surplus exists — that is, when the total assets of the company exceed all its debts and all the capital stock outstanding. Preferred stock usually is also entitled to first claim on the assets of the corporation in case the company closes up its business. The buyer of any preferred stock should learn before buying exactly what preference it has. "Investigate before you invest."

Types of Security to Be Offered in Seeking to Borrow

In seeking to borrow the funds or credit of another, one should carefully consider the type of security he is able to offer. Upon this security will depend largely the possibility of his borrowing and the rate at which he can borrow.

Many who look upon borrowing as perfectly proper, think it a disgrace to have to give security for the debt. "My credit is good; I do not have to give security," seems to be their slogan. But if by giving security one can get more of the funds he needs, and more readily, and possibly at a lower rate of interest, shall he stand in his own light by refusing to accept these advantages which the giving of security brings him?

The Financial Statement of the Borrower. — This is not strictly a "type of security," but it is likely to be called for whenever one wishes to borrow, and it often happens that a good business statement enables one to borrow what he needs without offering security, so it should not go unnoticed.

Frequently the prospective borrower resents the request for a business statement as "prying into my business." But he must recognize that he is asking the lender to trust money or credit in the borrower's business, and that the lender is more likely to do this and on better terms in proportion as he is convinced of the soundness of the borrower's business. Hence, his request for a statement of the borrower's properties or assets, and a complete list of his obligations or debts.

Often the borrower's objection is due to his not having such a statement ready, but the banker will, if the applicant answers questions accurately, soon set one up. (This is a good argument for keeping farm accounts; the county agent will secure for one a farm account book with helps for keeping farm records and setting up the financial statement.)

Mortgage on Real Estate. — The type of security most familiar in the community is the farm mortgage. In form, the amount borrowed is represented by a promissory note, or by a group of two or more notes possibly coming due at different times. The security offered is really a deed to the real estate mortgaged, in which the borrower deeds the real estate over to the lender, but with a clause reading in substance: Provided always that if the borrower shall pay or cause to be paid to the lender the sums of money mentioned in the following described note then this deed shall be void.

This real estate mortgage is used, generally, for only relatively large sums needed in purchasing a farm, erecting buildings, or making other extensive improvements. The money for these long time mortgage loans comes largely from trust funds and time deposits of banks, from the reserves of life and fire insurance companies, from savings of individuals, and from proceeds of sales of Federal or other farm mortgage bonds to whoever cares to invest in them.

Chattel Mortgages. — For smaller amounts borrowed for relatively short periods of time, the security offered is frequently a chattel mortgage — that is, a mortgage on livestock, machinery, grain, or other personal property. Like the real estate mortgage, it is in reality a transfer of title to the mortgaged chattels, with a clause making the whole transfer of title void in case the promissory notes which the mortgage is to secure are paid in accordance with their terms. Such a mortgage allows the borrower the possession of the chattels in the meantime. This form of security will unquestionably be used more in future than in the past. It is the type of security used for paper offered to the Production Credit Associations and other agencies which rediscount through the Federal Intermediate Credit Bank; also used by the so-called "finance companies" operating under the Chattel and Salary Loans Act. Installment sales frequently are protected by chattel mortgage. The extent to which farmers borrow on chattel mortgage has rapidly increased of late.

Collateral. — The security used in dealing in stocks and bonds is generally the stock or bond itself. For example, suppose you buy a $1000 bond, giving your note for the last $400 of its cost. You would probably leave the bond with the bank as security for the note. Similarly many a farmer and many a city man in the years since the war has had occasion to appreciate his ownership of a Liberty Bond or some other good bond or stock, which he could use as "collateral" in temporary borrowings. One can also allow his bonds or stock to be used as collateral for another person's loan or debt.

Co-Signer of Note. — Frequently a young man in his early ventures in business needs more capital than he has. Sometimes a relative or friend "goes on his note," that is, signs the note with him or endorses the note. The young man is the principal debtor, but all holders of the note in due course have the right to collect from this co-signer or indorser, in case the principal debtor fails to pay. The Morris plan banks loan regularly on a note signed by the borrower, and two other signers. Some finance companies also loan on this plan.

Pledge or Pawn. — Another type of security is the "pledge," in which case the borrower leaves with the lender some article of value, as a watch, a diamond ring, or his overcoat, as security for the repayment of a loan. This type of lending has been subject to abuses, the business is in more or less ill-repute, and its operators are required to obtain a license and to make daily reports of their loans. It is, nevertheless, one of the oldest forms of credit. There is probably no country of Europe whose royal plate and jewels have not been at some time pledged for loans. Today, it is a source of emergency funds for any purpose, from student dates or family vacations to paying the taxes or the insurance premium.

Quite similar to the pledge in outward effect, but wholly different in origin, is the lien which the jeweler has on one's watch, the garage man on one's auto, or the Chinaman on one's laundry, for labor done upon them.

Instalment Payments. — The plan of making partial payments in regular amounts at regular intervals may be applied to almost any sale or loan. It applies best and is most commonly used in connection with the purchase of goods of some durability so that there is something to seize in case of delinquency. It is commonly handled in either of two ways: the bill of sale may contain a clause which retains title in the seller until all payments are complete; or, the bill of sale may pass title to the buyer at the time of the sale, but the buyer signs a chattel mortgage on the goods, which mortgage is released when payments are completed. In either case the contract contains a clause which authorizes the seller in case of delinquency in payment to "repossess" the goods.

The regular form for bill of sale of an auto in this state does not pass title to the car. Likewise in case of piano, radio, washing machine, or refrigerator; I may be making payments on an article which is in my possession but which someone else owns until my payments are complete.

The "land contract" is similar in many respects to instalment buying. One enters into a contract to buy a farm; he pays a certain amount at the time of entering on the contract, and pays an agreed upon amount each month, quarter, or year. He has the possession and use of the farm, but title to it remains with the seller. The contract may leave title with the seller until payments are complete, or may indicate that when, for example, 50 per cent of the price has been paid, title shall pass to the buyer, and he shall give a mortgage to the seller for the balance. City residences or business buildings are sometimes sold on a similar plan.

Interest Rates — Why They Differ

The individual borrower is often dissatisfied with the rate of interest asked of him; he hears of railways borrowing at 4 per cent or 5 per cent, of "call money" at 2 per cent or less, of government's borrowing at various rates down possibly to less than 2 per cent. Why should loans to him cost much more? A review of some of the influences underlying these differences may be of interest.

Cost of Placing and Supervising the Loan. — One reason for higher interest rates is the original cost of placing the loan, keeping the records, sending out statements, and making collections. When a borrower has paid for an abstract of title, he feels that he has paid the costs of placing the loan, forgetting that maybe the bank's attorney spends some hours examining the abstract. Those who make a business of lending money spend money and time on lists of chattel mortgages, on study of business statements, or study of conditions affecting a particular business. "I'm busy today; can you come in tomorrow?" may mean simply a need for time in which to look into the question before deciding. All this labor and time must be paid for in the interest rate on loans made. It must be remembered, too, that the smaller the amount or shorter the period of the loan, the higher these costs relatively. In all mortgage loans, the cost of appraising the properties to be mortgaged must be cared for either in a special fee, or in the interest rate; when cared for in the rate, the rate seldom covers the costs on loans below $100.[1]

Risk. — An element generally recognized as affecting interest rates is that of risk — risk of loss of principal or interest, or risk of delay in payment. Actual losses; delays that deprive the lender of the use of his money, or involve correspondence, travel, or legal costs to secure collection; the reputation of a given type of loan; the reputation of the borrower himself as to any of these elements of risk — all of these factors help to determine the rate for the loan to that borrower.

The fuller the lender's information, the less the risk he is taking; a complete financial statement from a borrower often procures him a loan more readily, or on better terms, than that granted some other borrower whose actual financial standing may be better but who either will not or cannot give a good financial statement.

Type of Security. — Closely connected with risk is the quality of the security. It has a bearing on interest rate both directly and indirectly — directly, in that the same lender may loan at one rate on one type of security and at a different rate on another; indirectly, in that a refusal of one lender to loan on a given type of security — household goods, for instance — might send the borrower to another lender who charges a higher rate.

[1] "Personal Finance Business," p. 292, estimates the service charge necessary to cover costs on a $10 loan is 21 per cent per month, and on a $50 loan 5½ per cent per month.

An outstanding element in the security is the character and ability of the borrower. Farm mortgage lenders pay attention not alone to inherent values in land and buildings, but also to the farmer's ability as a farmer and his reputation for paying debts; short time lenders on specialized crops like fruit or truck crops are governed very largely by the proved experience and reputation of the borrower.

Marketability. — It is not always recognized that an investor in bonds, governmental or corporation, is really a lender. One thing most lenders are interested in is, How quickly and completely can I get my money out if I need it some time? Wheat can be shipped to the market any business day and sold at the going price; if one wishes to sell a horse or an auto he must find an individual buyer who wants that horse or auto. Wheat is, as a result, marketed at a very narrow margin as compared with horses or autos. Likewise the bond or other security quoted on the financial page, and on which one can realize its market worth on a few minutes' notice, will not require so high a return (rate of interest) as will an individual farm mortgage, an individual loan of any kind, in fact. The extreme influence of this factor is seen in the low rate on call money, that is, money whose return the lender can demand on 24 hours' notice.

Bargaining Power of Borrower. — Another factor in the rate one pays is the bargaining power of the borrower. A borrower who knows of only one source from which to borrow, is badly handicapped in borrowing, especially if he is in distress for funds and the lender knows it. It is worthwhile to cultivate acquaintance with the various sources of funds and the methods of operation in each case in preparation for the time of need. One should recognize, too, that often in interest rates, as elsewhere, "things are not what they seem." For example, one type of loan calls on the borrower to give a $100 note, repayable at $2 per week for 50 weeks. For the investigation, $2.00 is charged, and the note in discounted at 7 per cent for the year. The borrower thus receives $91 and has the use of it for one week, of $89 the next week, and so on. Figuring the $9 of costs for his loan, one finds him paying for the use of the money he has at a rate of over 20 per cent per annum instead of the 7 per cent rate which is discussed with him — not so much lower in reality than the firm which charges 2 per cent a month on monthly balances.

Legal Rate. — The maximum rate allowed by law is also a factor in determining interest rates. It unquestionably results in lowering rates for many loans. However, the lower the rate which the law allows, the more it forces evasion of the law and even forces into hands of outlaw dealers business which for risk or other reasons cannot be handled within legal rates. Many a borrower in western states where the legal maximum was 10 per cent, has borrowed $5000 at 10 per cent under the requirement that possibly $1000 be left on deposit in the bank without interest — only one of many forms of evasion. The legal rate of the state — the rate overdue or interest bearing transactions shall carry when no rate was agreed upon — is of great importance. Many persons question the value of a maximum rate.

Demand and Supply. — The United States borrows money mainly by the sale of its bonds. It has been customary to regard the rate on long time United States bonds as a fair measure of pure interest rate. If the reader will check over the preceding list of factors influencing rates, he will find little to affect the rate on United States bonds in recent years up to 1930. The heavy increase in United States debts in time of peace during the period 1933-1934, together with the actual changes (and the fears in the minds of investors as to further changes) in the character of our money, have unquestionably made some buyers hesitant and resulted in lower quotations on these bonds. But disregarding this element of risk for the moment, what is it that determines the underlying rate around which other influences work?

An interest rate is merely a price at which one party turns over to another the use of certain funds for a given time. Like other prices, it varies with the demand and the supply. During the years 1925 to 1928 business enterprises were expanding and funds were also in demand for speculation in securities; this demand resulted in a general upward trend of interest rates. On the other hand, since 1930 there has been a definite downward trend, due largely to the following factors: (1) business enterprises have not seen opportunities for profit, so have hesitated to expand or to invest much in new construction; (2) with corporations generally reporting losses or at best small gains, corporation securities offered no encouragement to investors; (3) even those enterprisers who thought they saw opportunities for profit often had difficulty in convincing bankers that a loan would be repaid; and (4) Europe had shipped immense quantities of gold to the United States, hence, idle funds were accumulating in banks and deposit vaults, at the same time that demand for funds had declined.

It should be recognized, too, that not only does this law of supply and demand work in the general field of determining the underlying interest rate, but there is a varying supply and varying demand in each of the various lines of lending. In the years 1933-1934 that were many farm mortgage foreclosures; due to low prices, farm incomes out of which to pay principal and interest on loans have also been low; most of the joint stock land banks were in financial difficulties; even the Federal Land Banks had much delinquency of payment on the loans due them. As a result, so doubtful was the probability that investors would buy Federal Land Bank bonds at par that, rather than offer them for sale, a loan was made from the Reconstruction Finance Corporation on an issue of bonds as security; later, Congress placed the government guaranty on the payment of interest on a large issue; later still, Congress authorized an issue of two millions of Farm Mortgage Corporation bonds, of which it guarantees both interest and principal.

During the time while land bank bonds needed this artificial support, the idle funds of business men "waiting for conditions to improve" and of speculators "waiting for the market to show signs of recovery" were seeking investment. The owners of these funds realized or hoped at least that they might need the funds on relatively short notice; therefore they did not want long time investments, like farm mortgage bonds; but did want safe short time investments, so that even when conditions were almost at their worst, the Intermediate Credit Banks were able to borrow on their 90-day debentures at not much above 1 per cent per year, and the United States government floated one loan of 30- to 90-day notes at a very small fraction of 1 per cent.

Further Illustrations of Variations in Interest Rates. — Demand and supply vary also in different areas. For example, interest rates are higher in the west and south than in northeastern United States. The northeast is the older section; its natural resources of timber, soil, coal, and iron are well developed — some of them, in fact, rather thoroughly exploited; it has through manufacturing, world trade, and financial services amassed immense capitals and credit; it is the great center of loanable funds in this country.

The west and south are busily engaged in developing their resources of timber, mine, soil, oil deposits; the demand for capital is relatively greater than in the east, the supply less. Then, too, in a rapidly developing area risks are greater than in an area of established industry; especially to the eastern lender the risks of investment 2000 miles away, in industries which he knows only at second-hand, if at all, seem greater than the risks of investment in industries right at hand. Hence, supply and demand and the element of risk influence western and southern interest rates, forcing them higher than in New England — and these are simply two of the major forces at work.

The farmer often feels that injustice underlies the 5 per cent or more which he pays on a first mortgage on his farm, while big corporations borrow at 3 to 4 per cent on what he feels is no better security than his farm. One element in the difference is the cost of placing the loan. All the investigation of titles and personal credit of the borrower must be charged against the $2000 to $10,000 of the farm loan, often to be repaid in a period of 3 to 5 years; in case of the corporation bond, the cost, while immensely greater, is distributed over a 10 to 50 million dollar loan and over a period of 10 to 99 years. Again, when interest on the mortgage is due, the lender is not sure of prompt payment, and probably makes collection through some distant bank and at some expense. As holder of a bond, he merely clips off the coupon, and deposits it at his bank the next time he is making a deposit, and is done with the transaction.

Again, the farm mortgage normally runs only a few years and he must seek a reinvestment. Possibly the farmer repays two or three years before the notes are due, and reinvestment comes in irregular amounts and at unexpected times. On the other hand, if the investor should find his plans changed, as a result of which he needs the money, in case of the mortgage he or his banker must hunt up an individual buyer who will take it off his hands, while in case of the bond quoted on the market, he can sell on any market day and a glance at the financial page of the daily tells him what he will get for it.

The Federal Land Banks were established to get away from some of these handicaps of the farm mortgage. The bank handles all the details of each mortgage; it puts up a bundle of the mortgages as security for an issue of land bank bonds. So the investor has all the advantages of a quoted bond and the coupons, while the mortgagor has the advantages of long time amortization, and low interest rates.

The Commercial Bank as a Lender

NOW THAT we have examined some of the business instruments used, and some of the factors involved in borrowing, we are ready to look at the institution that first comes to mind when we think of borrowing. The bank can usually arrange for one's borrowing for any length of time or for almost any legitimate purpose. A group of banks may float a bond issue through which Goodyear Rubber or Loew's Theaters borrows millions; your local bank can arrange a mortgage loan on your house or farm (though the local bank may or may not itself carry this loan). The principal business of the bank, however, is with short time loans — the 15-to 90-day loan to merchant, manufacturer, or to service organizations like laundry, garage, or plumbing firm; loans to professional men; loans to consumers for house repairs, hospital bills, and the numberless emergencies of life which call for more money than one has at the moment but which he can presumably repay in the next few months. The meeting of such needs rather than the needs represented in bonds, debentures, and real estate mortgages is the prime function of the commercial bank.

Sources of the Bank's Loanable Funds

The bank's funds to loan arise, first, from the sale of its capital stock; secondly, from the surplus whether subscribed, or whether surplus and undivided profits gradually accumulated from earnings; thirdly and principally, from deposits. For example, at the end of 1932 the banks which were members of the Federal Reserve System had outstanding 2409 million dollars in stock; they had surplus and undivided profits of 2587 millions and deposits of 23,943 millions.

These deposits are of two kinds, time deposits represented by savings accounts and certificates of deposit, and demand deposits, subject to check. The banker knows that the time deposits are likely to remain in the bank for some time, hence a considerable proportion of them can be put into mortgage loans. Even here he cannot be careless, for mortgages generally tie his money up for several years, while time depositors can demand their money in either a few months or at most a year.

Time deposits are generally overshadowed by demand deposits; in 1929 to 1932 the proportion was roughly $3 of demand deposits to $2 of time deposits. The owner of a checking account may on any business day draw out any part or all of his credit balance. On any business day several of the bank's depositors do draw down their balances materially; conceivably all of them might do so. If a large number do this, especially if rumors and excitement accompany the process, it is called a "run" on the bank. In general, however, as some are lowering their balances, others are increasing theirs, so that the bank's total deposits may not fluctuate greatly for weeks at a time. Hence, the banker feels safe in loaning out a considerable portion of his deposits.

As the interest on loans constitutes the bank's principal source of income, the more deposits it can get and the larger the proportion of them it can keep loaned out, the larger the earnings of the bank.

We must remember, too, that loans do not always mean money drawn out, nor do deposits always mean cash brought in. A merchant, in order always to be ready to take advantage of discounts on purchases, may desire to maintain a sizable checking balance. If his balance is getting low, he may call at the bank and deposit his note for $2000 for 90 days; this increases loans by $2000 and increases his checking balance by all of the $2000 except the bank's charge for interest — and all without a dollar's change at the time in the bank's cash.

The Banker's Problem

Every industry is likely to have seasonal fluctuations in business — times when its sales, collections, and consequently its bank deposits are high, and other seasons when it is buying materials in quantity, or manufacturing a stock of goods to meet a seasonal demand later; hence it will be drawing down its deposit, or even borrowing. City, county, and school district units which keep their funds in the bank receive their tax returns at given times, and pay them out over intervening periods. The banker has to study the seasonal changes in all these deposit balances of industries, governmental agencies and individuals; he has to anticipate the needs for extra pocket and till money which go with the "fall trade" or the holiday trade.

He wants to keep as much of his resources as possible bringing in interest; he must, on the other hand, always be ready to pay all checks drawn on his bank. He tries to anticipate his probable needs, and to have loans coming due in largest quantity at the time when his needs will be greatest. The more of his loans which are due in 30 to 90 days, and the fewer due in 6 to 12 months, the easier his problem. Hence, his preference for short time loans, and hence the law permitting the Federal Reserve Bank to rediscount commercial paper with maturities not exceeding 90 days.

In a period of uncertainty and of less than normal confidence in banks, and of excessive withdrawal of deposits, he is more than ordinarily fearful of many long time loans, and may refuse to loan for more than 6 months, or even 90 days.

Recent Difficulties of Banks

This short bulletin is not the place for a discussion of the whole banking problem. The difficulties of city banks we shall not discuss at all. But the country bank has extremely acute problems of its own. The farmer patrons of the country bank need 6 to 12 months' loans for production, and when they need a farm loan it is a loan of 3 to 7 or even 10 years. The few 60-day or even 90-day loans needed by the village merchants and service agencies plus similar needs of farmers use only a very small percentage of the country bank's funds. Hence the tendency of the country bank to let altogether too much of its resources get tied up in long time loans.

Worse yet, during the past four years the declining prices cut into farm incomes, cut down or destroyed new deposits, and forced many farmers to withdraw part or all of the deposits of earlier years. Where could the bank get the funds with which to meet this demand for deposits? It must be recognized that besides the cash in its vaults, a bank makes a practice of keeping secondary reserves:

1. Funds in other banks subject to call.
2. A sizable bundle of United States, state, and city bonds immediately salable.
3. A bundle of other stocks and bonds of not so high class but yielding greater income.
4. A portfolio of good short time loans which it can rediscount with (sell to) the Federal Reserve or other banks.

In 1929-33, deposits were being rapidly drawn down, and at the same time collections were slow on loans owed to the bank by farm and village borrowers. But why not sue on the debt and get a judgment? Why not foreclose the mortgage? When in ordinary conditions an occasional mortgagor fails to meet his payments, foreclosure may be the remedy. But when after a period of land speculation, banks and insurance and real estate companies hold mortgages on a large proportion of the farms, a different situation exists. If farm prices decline, as in 1920-21 and again in 1929-30-31, and dozens of farmers fail to pay interest, to say nothing of any part of the principal, what shall be done? Five foreclosures in a township, five forced sales of farms, at a time when nobody is in the market to buy farms, would squeeze the water out of land values so fast as to imperil the whole thousand or so of mortgages in the county. When the bank examiner comes along, the banker talks about "frozen loans." The examiner just came from a city bank, where possibly he heard the same complaint, only there the security was corporation stocks; the city banks saw the danger of forcing billions of dollars of securities on the market just as the country banks and insurance companies saw the danger of foreclosing farm mortgages.

With deposits going down, and collections slow and often impossible, the cash reserves in the bank vaults were rapidly depleted. Then the bank fell back on its secondary reserves.

1. It was hard to get the funds it had in other banks; that city bank, in fact, might be in liquidation; for instance, nearly every northwest Ohio bank had part of its funds "tied up" when several large Toledo banks were closed.

2. Many banks were selling bonds and stocks in order to pay their depositors; many speculators were selling part of their bonds and stocks so as to pay their debts and manage to keep part of their holdings; very few had the means or the inclination to buy. So prices of bonds and stocks were going down like a dead skyrocket.

3. The "good short time loans" rediscountable with the Federal Reserve Bank were soon exhausted; even some of them might prove not so good.

Part of the influences discussed above affected all banks, but several of them affected especially the small town banks. Of the 5700 banks closed during the period from 1929 to 1932, half of them had capitals of $25,000 or less each, and half of them — largely the same banks — were in towns under 1000 in population.

Another thing that helped to deplete cash was the fear of depositors. When banks were failing all around, depositors were fearful of the security of their deposits. They would draw out part or all of their deposit in cash, and put it into their personal deposit box. Many a bank went into receivership when there was money in the personal deposit boxes of its patrons, money which had been drawn from their deposits in that bank, to an amount which would have saved the bank had its depositors had confidence in it.

The new Federal Insurance of bank deposits is designed both to protect depositors, and also to protect the bank from this kind of deposit withdrawals. Another proposal in a bill now (June, 1935) before Congress would allow a local bank to rediscount with the Federal Reserve Bank good long time farm mortgages, as well as the short time paper to which rediscounts have been limited in the past. This would add materially to the funds usable by the local bank to meet withdrawals of deposits.

Borrowers' Methods

The banker in a city of 5000 or more has generally the larger proportion of his business with merchants, manufacturers, and service agencies of different kinds; he has also many depositors and borrowers.

The merchant who borrows from him is already a depositor, and probably bringing in checks and cash for deposit every business day. When he borrows it is by depositing a 60- to 90-day note for credit on his checking account, and much of the borrowed funds will not be drawn; he borrows, in other words, to maintain a sizable bank balance. He gives the banker a complete statement of his financial condition. He wants the banker to be ready at any time to certify to his credit, so he is prompt in meeting his notes; and if for any reason he cannot pay, he is on hand, at any rate, to renew the paper and possibly give collateral security.

The farmer may do all the above — thousands of Ohio farmers do (except as to frequency of deposit); such farmers borrow as easily and on as good terms as anyone.

Other Sources of Short Time Credit

Aside from banks, the principal sources of short time credit are mercantile credit and the small loan firms.

Mercantile Credit

Mercantile credit dates back untold years; it differs in form and cost in different trade lines and in different parts of the country. In the south, a very large proportion of the smaller farmers are utterly dependent on some local merchant not only for farm supplies but for their living as well. The merchant carries the farmer from one crop season to another; the merchant is protected by a crop lien. The farmer must do practically all his trading with that one merchant, and pays prices very much higher than if he paid cash. Under such circumstances, including the interest and other costs of the advances plus the excessive prices paid for supplies, the cost of his borrowing to the farmer is estimated at anywhere from 25 per cent to 75 per cent per year.

No such conditions prevail in the north, but even here the cost of mercantile credit is high — generally far higher than its users recognize. The buyer of an automobile on the instalment plan frequently pays in excess of the cash price at the rate of 4 per cent or 5 per cent per month on the amount of debt owed; this is not all interest, as it usually covers fire, theft, and collision insurance, but is an expensive way in which to buy any of the services named. The man who lets a 3 per cent discount for cash pass, and then settles 30 days later at invoice price, is paying 36 per cent per year for the use of the money. The cash discount on fertilizer is often 5 per cent. Any number of farmers do not pay cash but settle 30 to 90 days later, suffering costs at the rate of 60 per cent and 20 per cent per year respectively for the use of the money. Mercantile credit is frequently the most expensive type of credit.

Goods are often advertised for sale on "Easy payments."[1] A refrigerator was offered on terms which permitted the buyer to pay the last $75 at $10.05 per month for 8 months; this figures up at approximately 20 per cent per year on the average balance owed. Another refrigerator offer allows the last $100 to be paid in 6 monthly instalments of $17.88 each — a rate of more than 25 per cent per year. A $50 radio offered at $7 cash and $4 per month for 12 months involves a cost of about 20 per cent per year on the balance owed.

It is probable, too, that in most cases these terms are not offered by the merchants in the thought of making money by the terms — it is safe to say the dealer would rather have the cash when the deal is closed. The extra charge is to cover not only interest but the half dozen or more receipts and bookkeeping entries, and the dunning letters, collection costs, and losses which are bound to go with some sales on time. We call attention to the rates merely to point out the wisdom of borrowing elsewhere and paying cash rather than buying on instalments.

Mercantile credit is expensive generally to the giver as well as to the receiver of it. Chain stores offer as one of their advantages over many independents, that the chain is free from the expense of bookkeeping and losses on accounts. The farmers' elevators, service companies, and merchants who sell "on time" have to charge yearly thousands of dollars of expense and loss to their practice of selling goods by this method. In one year the farmer elevator companies of Ohio charged off to this cause more than $100,000 of loss.

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[1] See Extension Bulletin 161, "How Easy are Easy Payments?" Agricultural Extension Service, Ohio State University.

The Small Loan Firms

The small loan firms are of various types, from personal loan departments of banks through a long chain of industrial banks and pawn shops to the unlicensed lender. Operating originally and mainly in the city, they are in the past few years making increasing loans to farmers. The legal limit for interest in Ohio is 8 per cent per year. An exception to this 8 per cent limit is made in the so-called "Chattel and Salary Loans Act" under which, on loans up to $300, any rate may be charged up to 3 per cent per month on the balance outstanding. (The $300 limit may be evaded by forcing the borrower to borrow from two companies.) Any dealer before he is eligible to operate under this law must take out a license and agree to permit inspection of his records and to make such reports as are required of him. One firm making these loans charges 3 per cent per month on the first $200, 2 per cent per month on the next $100, and 8 per cent per year on all above $300.

Much bitter invective has been directed toward the "loan shark" and all too often it is justified. But the writer is satisfied that the general public needs to revise its attitude on this phase of the lending question. It costs nearly as much time, travel, making out of papers, appraisal of property, bookkeeping, correspondence, etc., on a $50 loan spread over 12 months as on a $500 loan, so the smaller the loan the higher the costs when figured on a percentage basis. But if the maximum rate allowed is 8 pe rcent per year, it should be recognized that the 8 per cent must cover not alone the use of the money, but all the costs of placing the loan, examining title, bookkeeping, correspondence, possible collection costs, and losses.

But thousands of loans are asked and granted under conditions in which 8 per cent would not cover these costs. Might a poverty stricken family mortgage its household goods and at a pretty high rate rather than go without coal or groceries for a winter? Might one be ready to "sell part of his salary" for a few months rather than let his wife or child suffer for lack of hospital care? And people will borrow for numberless purposes which you or I might not regard as necessary — in fact which the debtor himself, once away from the high pressure salesman, regards as unnecessary.

The fact is that thousands of people will buy and will borrow at unbelievable rates of interest, and persons can be found who will lend, law or no law, if borrowers will pay high enough rates. And one may in righteous indignation at the practices of certain lenders condemn small loans firms as a group, and demand that they be wiped out of existence. (Those who take this position tacitly assume that if penalties were severe enough on high rates, loans could be gotten at low rates — which does not follow). Or one may recognize that there are needs for short periods of time which are going to be satisfied regardless of law, and that it is better to legitimize dealings within certain limits and under state supervision, than to leave to outlaw lenders all borrowers whose loans cannot be handled on 8 per cent per year.

The Ohio law requires a lender at any rate above 8 per cent per annum to take out a license with the division of securities, pay $100 a year fee therefor, submit under oath to examination of his records as often as the commissioner sees fit, and further lays down provisions for the protection of the borrower. Such licensees may charge up to 3 per cent per month on monthly balances, with no compounding of interest; 3 per cent a month is at the rate of 36 per cent a year. Most of the advertisements to "loan at the legal rate" refer not to 6 per cent or 8 per cent, but to this 3 per cent a month.

The business of these small loans companies for the United States as a whole runs to 400 millions of dollars a year. The number of such loans in rural Ohio is rapidly increasing. Monthly payment plans are unsuited to farm borrowing generally; some small loans companies do not require monthly payments from farmers. Certainly these loans in a farming community should be limited to emergency loans; no farm enterprise will pay returns of 3 per cent per month. The farmer who has chattels can borrow at much more reasonable rates — say 6 per cent to 7 per cent per year to cover all costs.

The Federal Government and Farm Credit

When the Federal Reserve System was set up in 1914, it was recognized that long time mortgages on farms were mainly outside the field of the Reserve System. In 1916 were established the Federal Land Banks to care for this type of credit need. At that time the short time needs of farmers were being pretty well cared for by local country banks; deposits were high, which made lending easy, and farm incomes were high, making lending relatively safe — at least it seemed safe.

Drouth and other misfortunes brought disaster to farmers of certain areas, sometimes sizable areas, and Congress provided emergency loans, administered by the Treasury Department or by the Secretary of Agriculture, in several of the years from 1918 to 1934. The drastic price decline of 1920-21 hit farm incomes especially; it thus reduced the farmers' ability to pay obligations and also the power and readiness of the banks to lend. Between the local bank's loans of 60 days to 6 months and the Federal Land Banks' loans for 5 years or more is the area — the period of time — for which the farmer makes his short time loans. Therefore, in 1923 Congress provided for the Federal Intermediate Credit Banks to make loans up to 3 years' duration.

By 1933 the Farm Board, the Reconstruction Finance Corporation, the Intermediate Credit Banks, and subsidiaries of all three of them, together with the various emergency loan organizations made a multiplicity of agencies, at once confusing to the prospective borrower and productive of duplication and expense. Hence, the President's executive order and later the Credit Act of 1933 establishing the Farm Credit Administration, in which are consolidated all the agencies for loans to farmers and their organizations.

The Farm Credit Administration

The Farm Credit Administration (F.C.A.) consists of a Governor and his immediate staff, under whom are the four commissioners each in charge of his particular group of banks, namely, the Land Bank Commissioner, the Intermediate Credit Bank Commissioner, the Production Credit Commissioner, and the Cooperative Credit Commissioner. At Louisville, Kentucky, the headquarters of the district in which Ohio lies, we find a Federal Land Bank, an Intermediate Credit Bank, a Production Credit Corporation, and a Bank for Cooperatives. All these agencies publish at frequent intervals bulletins and circulars describing their set-up and methods. We shall not in this bulletin attempt any description of their work, for by writing to the Farm Credit Administration, Louisville, Kentucky, any inquirer can get information more complete and more up-to-date than anything we could furnish.

We shall, however, note a few general facts in passing.

1. One must distinguish between the emergency loans of the past few years which were partially relief measures, and on the other hand the loans by the above mentioned agencies, which are expected to be repaid as surely and as promptly as the loans of any bank. The F.C.A. agencies are intended to be permanent rather than emergency agencies.

2. It is to the farmers' interest that the loans be sound. The money loaned is not Federal funds, but funds raised by the sale of bonds or debentures which in turn are secured by a deposit of notes and mortgages arising from earlier loans. The sounder the loans, the more attractive to investors the bonds will be, the lower the rate of interest the bonds must bear in order to sell at par, and consequently, the lower the rate at which farmers can borrow.

3. In case of both the Land Bank loans and the Production Credit loans the borrower must take stock to the extent of $5 for each $100 borrowed; when a cooperative borrows from the Bank for Cooperatives, it must take a $100 share for each $2000 borrowed. The purpose of this requirement is to give the farmer borrowers the ownership and control of the agencies from which they borrow — which has been demanded by farmers and farm organizations for years.

The Production Credit Associations

The Federal land banks have for years cared for the farmers' long time loans, but his needs for production loans for 6 to 12 months' periods have not been so well met. In early 1934 Production Credit Associations were set up over the United States to meet this need. Twelve of these are in Ohio, and their locations are shown on the accompanying map.

Location of Production Credit Associations, and territory served by each.

In the first 15 months of operation, these associations had made approximately $2,500,000 of loans of this kind to Ohio farmers.

By inquiry at the county extension agent's office, the farmer can learn where in his county he may find help in making an application.

Mistaken Impressions Regarding Credit

In the interest of clearing away some of the mental underbrush which interferes with clear vision, it seems wise to comment briefly on some notions which one hears frequently expressed.

1. *That banks gain by depression or community disaster, and desire it to occur.*

Banks are normally most prosperous — make most money — when other businesses are making money; their gains are built on the demand for their loanable funds by enterprises which pay promptly and are making money, and so are able to pay good interest rates. On the other hand, the price drop of 1920-21 set in motion a series of business disasters which caused 5642 banks to fail during the period 1921-29, or an average of 700 banks per year; then in the next two years 1929-31, 3635 more banks went to the wall, or 1800 per year. Every depression has had the same general outcome. Is it sensible to believe that banks deliberately bring about conditions which cause failure to a third of them? The banking system had weaknesses — several of them; business changes were going on with which our banking laws had not kept pace. But the fairer way to put it is that banks were caught in the same disasters as the rest of us, and our disasters fell finally on them. However, one effect of the bank failures will be to leave larger territory and volume of business to the respective remaining banks.

2. *That the price crash of 1920-21 was due to the withdrawal of money from the farm areas to send it to eastern banks.*

By December, 1920, farm prices had declined to less than two-thirds of what they were in April of that year. During all this time the volume of money in circulation was increasing, the Federal Reserve note circulation having increased in that year by 560 millions of dollars. And, too, money was being sent not from west to east, but from east to west. As early as April, 1920, the Reserve banks of New York, Boston, and Cleveland had rediscounted paper for (that is, had loaned money to) banks farther south and west. By September, these loans to the banks of Chicago, Minneapolis, Kansas City, St. Louis, Dallas, Atlanta, and Richmond by the four eastern banks (Philadelphia included) had reached 225 to 240 millions of dollars. In fact, one of the purposes in creating the Federal Reserve system in 1914 was this very transfer of funds to areas of shortage.

3. *That, if the Government or the Intermediate Credit Banks can borrow for 60 days or 6 months on a basis of less than 1 per cent interest per year, they should be able to loan on farm mortgages at 2 per cent per year.*

But the loans on farm mortgages are for 20- to 33-year periods. Suppose you, as an individual, were told by some lender that he would let you have a thousand dollars for 6 months at a rate of 1 per cent per annum. Would you feel safe in lending that $1000 at 2 per cent in a loan of 30 years' standing? No; nor is it any sounder economics for a government to do it. It may be wise for other reasons for a government to reduce temporarily the rate of interest on certain types of loans, but no lending agency can safely tie up funds in long time loans at rates determined by 90-day borrowings.

4. *That present low interest rates indicate permanent low rates.*

Not necessarily, in fact not probably. The government has set as one objective the maintenance of low interest rates; without doubt it can exert a strong influence in this direction. However, billions of dollars are awaiting business recovery to be invested in manufacturing, mining, and commercial enterprises. It is this activity of business that creates demand for funds and that earns the profits which makes possible high interest rates. Every depression develops a period of low business activity, with ample funds and low interest rates, to be followed normally by increasing activity, increasing demand for money, and advancing interest rates. So we may not be able to borrow indefinitely on the present low basis.

5. *That, with the Intermediate Credit Bank borrowing at 1 per cent, and rediscounting or lending at 2 per cent, the addition of 3 per cent by the credit association is adding too much.*

Is 3 per cent too wide a margin?

No, as a general proposition. For example, in the period before 1933, the Intermediate Credit Bank would rediscount farmers' notes for any sound financial agency if the note did not bear a rate more than 3 per cent above the Intermediate Credit Bank's rediscount rate. Almost no financial agency regarded a 3 per cent margin as sufficient to offer a profit, over the costs of placing and following up such loans, doing the bookkeeping and correspondence, taking the risks of delay, collection costs, and losses; hence in setting up new agencies, the Government thought it unsafe to ask them to operate on any margin lower than the one which existing agencies thought already too low. Certain types of loans — feeder loans, for instance, can be handled on a lower rate; will each type of loan some day get the rate to which it is entitled?

6. *That in granting a loan, the test is the amount of security.*

No. The probability of payment is the test. No legitimate lender wants a collection of chattels, or the necessity of foreclosure. His questions are — Will the borrower be able to pay? Will he pay, or has he a reputation as "slow or doubtful pay"? Security is taken primarily to protect the lender in emergency, to protect both borrower and lender from seizure of the working capital by some other creditor, and also for the influence it will have on some borrowers to make them more thrifty and more careful to pay.

Some Terms Explained

Discount and Rediscount

The privilege of using funds furnished by someone else is a thing of value. One may pay for this privilege in either of two principal ways. For example, suppose that one wishes the use of approximately $100 for 6 months, when the use of money is worth 6 per cent. The banker may hand him a note, in which the borrower promises "to pay $100 with interest at 6 per cent"; when the borrower signs this, and hands it to the banker, the banker gives him $100 in money or in credit on his checking account. At the end of 6 months the borrower pays the bank $100 plus $3 interest, or $103. On the other hand, the note which the borrower signs and returns may call for the payment of $100 at the end of 6 months and not require any addition for interest. In this case, at the end of 6 months the borrower pays $100, but at the time he gave the note the borrower received $100 less the $3, or $97. The $3 is really interest paid for the use of money, but taken out in advance is usually called "discount," and the banker is said to have discounted the note.

These notes of its borrowers the bank may keep in its own files until paid. It will likely use part of them, however, to replenish its funds, and sometimes to increase its balance with its correspondent bank. Suppose some manufacturer in the Cleveland area, doing business with the Blank National Bank of that city (all national banks are members of the federal reserve system) and, wishing to increase his checking account balance by about $50,000, delivers to Blank National Bank a note for $50,000 payable in 90 days without interest. If money is being loaned at 6 per cent, the bank computes 6 per cent on $50,000 for 90 davs, finding it to be $750. It credits his account with $50,000 less 750, or $49,250.

If, now, the Blank National Bank wishes to increase its balance at the Federal Reserve Bank, it may even the same day send this note with its endorsement to the Federal Reserve Bank. Assuming its rate on this kind of paper to be 4 per cent, the Federal Reserve Bank computes the discount on $50,000 for 90 days at 4 per cent, which is $500, and credits Blank National Bank $50,000 less $500, or $49,500. Thus of the $750 which the manufacturer paid for the use of the funds, the Blank National Bank got $250 for placing and guaranteeing the loan, and the Federal Reserve Bank got $500 for the use of its funds for 90 days. The Federal Reserve Bank is said to have "rediscounted" the paper.

Pyramiding of Loans

A bank thus by selling its customers' notes to some other bank for rediscount may gets its money to loan to someone else, and may do this more than once. Likewise an agricultural credit corporation may loan, say $1000 to A, on his note secured by a chattel mortgage. By rediscounting this note, it gets its money again, which it may loan to B; rediscounting his note, it can reloan the money to C, and so on. Thus, the corporation may be able to loan up to six or seven times its capital stock — the whole process sometimes being called "the pyramiding of loans."

Self Liquidating Loans. — Suppose that a manufacturer borrows money to buy raw materials, expecting the returns from the sale of the product to pay off the loan; or that a farmer borrows funds to buy poultry feed, later paying off the loan from returns of his egg sales — such are self liquidating loans. A self liquidating loan is one to forward an enterprise whose returns will pay off (liquidate) the loan. Barring emergencies, loans must in general be of this kind or any credit system will fail.

If one be ready to offer a business statement when he borrows; if he be ready to offer security as a means of gaining for himself the best terms; if he confine his borrowing to self-liquidating transactions; if he use the returns when received to liquidate his debt, he will have made his contribution to solving his credit problem. Until he thus utilizes the means already available to him, his ground is much less sound in demanding of his government further investigation and further steps for his relief.

Finally, whatever improvements are to be made in our rural credit system, ultimate success will be predicated on the soundness of the loans and the general promptness with which they are paid. No credit system can be stronger than the loans on which it ultimately rests.

Senior and Junior Mortgages

The holder of a mortgage should always see that it is recorded or filed at once. The date and hour of such filing or recording is stamped upon it. If two or more mortgages cover the same property, not the one dated earliest but the one recorded or filed earliest is known as the senior mortgage, and is claims must be satisfied before those of the holders of later (or junior) mortgages. There are however several ways in which for a time, or for a particular junior creditor, the holder of a senior mortgage may yield part of his rights without prejudice to the general seniority of his claim.

A Subordination Agreement is an agreement executed by a senior mortgagee in which agreement it is stipulated and provided that a junior mortgage shall be entitled to priority over the senior mortgage.

An Agreement Not to Disturb is an instrument wherein a senior mortgagee agrees that any lien which may be acquired during a specified period of time by a creditor of the mortgagor shall be entitled to priority over the senior mortgage, the senior mortgagee agreeing not to take any steps to enforce the payment or collection of the senior claim during the agreed period of time.

Waivers are of several kinds, for example, a landlord's waiver is an agreement in which the landlord waives any lien which he has or may acquire on property of the borrower in favor of a mortgage executed by the borrower. The priority of a senior real estate mortgage or a senior chattel mortgage may also be waived in favor of a junior mortgage by the senior mortgagee executing an instrument known as a Waiver of Priority.

It might seem peculiar that a holder of a senior claim would be willing to surrender his priority, and he should not be expected to without a reason, but there are numerous cases in which he may do so. Take the following cases. A retiring farmer has sold his farm to a relative or friend, and holds a mortgage on the farm and livestock. The buyer needs to borrow further working capital. Or, a landlord has a contract with his tenant calling for rent in the form of a part of the crop, but the tenant wants to mortgage the crop to secure more working capital. In another case a landlord and tenant owned jointly the dairy cattle and hogs, the landlord having furnished the bulk of the money to buy them and holding a mortgage on the tenant's half as security for the money advanced.

In numerous cases similar to those above, the holder of the senior claim recognizes that without added working capital the tenant or mortgagor would be badly handicapped, and that the borrowing of further funds to buy feed, a needed machine, or a horse or team, will add to the efficiency of his farming operations. Hence, he feels that to make it possible (by subordinating his own rights temporarily) for the tenant or mortgagor to obtain the new loan, will add to the probability of payment of his own claim. It may be good business, therefore, to subordinate his rights by waiver or other agreement.